Audio Transcript: Inflation in Full Retreat
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Katie Klingensmith [00:00:04] Welcome to today's conversation, Around the Curve, with Brandywine Global. I'm Katie Klingensmith, and I am delighted to be joined by my colleague Francis Scotland, who is the Director of Global Macro Research here at Brandywine Global. I think we started out 2023 with a very different perspective than all of us are ending 2023. And we're going into a 2024, which could provide a lot more transitions and surprises. So, it's a particular joy to welcome Francis and get his perspective on all that has been going on and all that we expect will happen over the next year. Francis, just get us started. Central banks have hiked really a lot over the past year, economies have continued to do really well, particularly in the United States. Is it possible that we can avoid a recession?

Francis Scotland [00:00:56] Good to see you again, Katie. Let's just back up for a moment before we really dive into that question. So, for the past couple of years, I've characterized the major macro developments happening in the U.S. and to a lesser extent in Europe as really the aftershocks of what I call post-pandemic normalization. What we've been going through has definitely not been your typical business cycle. I think of it more as a macroeconomic earthquake. We broke through the normal guardrails, and the economic and financial forces have been trying to get us back on track ever since over the last, at least over the last few years. So, as we close out '23, peer into '24, I think that a lot of this normalization story has already taken place. And yet, the investment outlook for next year, in my view, hangs on what I think might be the final iteration of this normalization story, which is really comes down to a handful of the most crucial macro and financial variables, which include interest rates. So, just for the sake of context, the pandemic lockdowns pushed us into a bust. Then the reopenings plus the massive stimulus gave us this rocket-like rebound across the board, which included crypto, equities, commodities, real estate, economic growth, job growth, price and wage inflation. Normal economic relationships were upended. Personal income and personal spending, for example, zigging and zagging in extreme distortions. And then in late '21, things started to reverse, just as if almost the rocket ran out of gas, started falling back to Earth, largely in anticipation of this big 180-degree reversal we've seen in U.S. and European monetary policy. And so things started to come down almost in perfect sequence in reverse to the way they went up. Crypto tanked in '22. We saw multiple compression across the broad equity market up to mid '22. But large swaths of the market, like small cap for instance, have fallen back, too, and remain pretty close to levels that were trading in late '19. Commodities have given up half their gains. Some commodities, like natural gas, lumber, are doing complete reversals. Single-family housing activity has retreated 25%. It's now within striking distance of levels that existed in 2019, prior to the pandemic. The real economy has slowed back to a 2% growth handle. Price inflation has been in full retreat now for 17 months. If we look at core CPI ex-shelter, it's 2% or less on a three-, six-, and 12-month basis. We know ex-shelter because the CPI method doesn't capture rent inflation very well. And so, when you measure this thing properly, inflation is much lower. So to all intents and purposes, normalization has brought us full circle back to where we started, which is a 2% inflation economy, 2% real growth. And a lot of this can be explained by normalization forces and these rapid improvements that we've seen over the last year and a half in the supply chain. So, it turns out inflation was transitory after all. It just took, with hindsight, it took longer to normalize than anyone was thinking at the time. Which begs the question, what's left to normalize? And I think the main things left are interest rates and economic policy. The inverted curve is telling us the Fed needs to cut rates in the future. It needs to ease up on monetary policy. And the budget deficit has never been this big, considering how robust

the economy has been, and it needs to be cut back. What does that mean for the economic outlook in '24? Well, historically, the yield curve has flattened, you know, with the economy sliding into recession and the Fed cutting rates. And our base case from the beginning has been that you did not need a recession this time for normalization to take place. That expectation was always based on the assumption that the Fed would cut rates or react to the lower inflation as the economy normalized in time to avert a recession. And by and large, that's still pretty much the core view. Obviously, the longer the Fed ignores this retreat in inflation, the longer the curve stays inverted, the higher probability of a recession or some discontinuous event that increases recession risk. So, the odds of recession, I don't think are trivial, but still not the most likely scenario because we're so constructive on inflation. The other factor which might keep us out of recession is fiscal policy. The amount of stimulus pumped into the system has been historic. I think the fiscal lift is beginning to fade, but these programs that have been put in place have very long tails.

Katie Klingensmith [00:05:31] So, Francis, there's still some risks out there. Is there the possibility of a hard landing in the U.S.?

Francis Scotland [00:05:39] There's always the possibility. I mean, you can't rule out anything. But as I said, I think that the main story here, at least driving my macroeconomic outlook, is the expectation of falling inflation, which removes any need for the Fed to keep raising rates, increases the probability the Fed actually will cut rates, which would be very stabilizing.

Katie Klingensmith [00:06:00] So tell us a little bit more about what you expect from prices. It sounds like the decrease in inflation, the disinflation, is something that you anticipated, and we've seen. What do you think is next, and what will be driving prices going forward?

Francis Scotland [00:06:16] Yes, I've been and remain very constructive on inflation. And if anything, I think that there's a good chance next year the Fed undershooting its target on inflation. So, we just look outside of the U.S. for a moment. There's no macro inflationary pressure coming from China. The economy's flirting with deflation. Traded goods prices, which we know are dominated by China, are falling. The Chinese authorities are being forced into incremental stimulus measures in order to contain the property sector deflation. So, the economy maybe will be able to grow at a 5% growth pace, but that's the slowest pace of growth China's experienced since it modernized 35, 40 years ago, not counting the pandemic busts. The authorities are pretty desperate for some self-sustaining growth, which is a big reason why President Xi made the trip to the United States in November and spoke to business leaders about encouraging them to reinvest in the Chinese economy. Governance issues in the economy under President Xi's leadership, particularly in the last few years, have led to an almost complete collapse in foreign direct investment. So, it's pretty hard to see direct investment scaling back up any time soon. There's nothing inflationary about Europe. Broad correlations between banking and money growth series point to really dismal nominal growth in this economy throughout most of '24. And even when you look at Europe's post-pandemic rebound, it really never made it back to the pre-pandemic trajectory in real GDP. So, this is a region which may be even more disinflationary than the United States. And in the U.S., what I think is a remarkable resilience of the U.S. dollar in combination with these external disinflationary, deflationary forces is really helping to suppress inflation domestically. So, in addition, you know, all the excitement over artificial intelligence comes with some important macro implications. If AI works to make companies more efficient, the companies spent a lot of money on

incorporating AI into their production process to maintain margins, especially in the face of what are now rising real wage costs, that should boost real potential GDP. And other things remaining equal, that would be another source of downward pressure on inflation. So summarizing, I think, you know, I think many analysts and observers have come to believe that the retreat in inflation is going to level out above target, probably closer to two and a half, 3% or maybe even higher. But from the normalization perspective and with the lagged effects of tight monetary policy yet to be realized, to me, the risks all point in the other direction of an undershoot on the targets.

Katie Klingensmith [00:09:02] So, it's been a pretty interesting scenario for bonds, and it's been a wild ride for fixed income investors the last couple of years. What else do you think will drive fixed income markets?

Francis Scotland [00:09:13] Yeah, well, you're right. After nearly three years and a 50% hit to the long-term Treasury total returns, peak to trough. Mean reversion and normalization argue for a pretty meaningful rebound in returns coming from a long-term Treasury duration. So, I think what we've seen recently is the start of something more sustainable. A lot of ink has been given to this idea that the neutral rate is higher than it was in 2019. I think this issue is real but exaggerated. Fiscal policy, in my view, has had a big role to play in creating the impression the economy is less sensitive to rates than before. But with fiscal lift, I think, starting to fade, I think it becomes more apparent that the so-called neutral rate is lower than what many perceive currently, and many of the factors that we've been talking about can and should drive the rally affecting long-term duration. But fundamentally, a major slump in nominal economic activity should be the main catalyst for a rebound in fixed income. So, the drift from my comments about the normalization perspective, the biggest part of that slowdown in nominal GDP, I think, comes through on inflation and price, less real economic activity. But as I mentioned earlier, if the Fed stays too heavy-handed, then more could come through on a weaker economy. If the Fed behaves according to my script, I would be looking for it to cut rates sooner and faster than the market is currently pricing. And so we could get the scenario of falling inflation and gradually real economic momentum might actually build by the end of the year.

Katie Klingensmith [00:10:53] So, that feels like a pretty constructive outlook both in terms of inflation and growth. What do you think are the biggest risks going into '24?

Francis Scotland [00:11:04] Outside of geopolitical upheaval, the risk of recession that we've already talked about, and of course, unknown unknowns, I think the greatest domestic threat in the U.S. may be fiscal policy and the upcoming election. The current budget deficit is unsustainable given the level of interest rates relative to the growth rate of the economy. There's nothing on the horizon to suggest any material change in government spending borrowing needs. Nor do either of the two most likely contenders for president in '24 provide a lot of hope for fiscal remediation. Trump likes to cut taxes. Biden likes to spend money. Because of this macro environment for much of '24 that I've described, I'm not sure this is going to turn out to be much of a material issue for next year, but it's a really important source of instability in the U.S. macro outlook, and one which I think is going to require a big adjustment at some point in the future, consequences of which would be felt across the economy and markets. As for the election itself, the polarization seems to be stretching the social fabric of the nation. Marginal success by either candidate could lead to some kind of backlash. All of that, to me, makes any significant fiscal consolidation a lot more difficult, especially now with the credibility of American fiscal sustainability is already under scrutiny, given these recent downgrades.

Katie Klingensmith [00:12:31] I can certainly think of some opportunities that would come up in a constructive growth and constructive inflation environment. But what opportunities are you focused on?

Francis Scotland [00:12:42] If monetary policy story plays out the way we've discussed, then I think we could be in a pretty strong year for investors in general. Valuation-wise, the bond market looks more attractive to me than the cap-weighted equity market. But there are clearly sectors within the broad equity market that are trading at a pretty steep discount to their intrinsic value, which I think would benefit from the scenario I think is possible ahead.

Katie Klingensmith [00:13:07] So, just bring this all together, Francis. Bottom line, and also in terms of just what people are not anticipating, what's the least recognized risks and opportunities in 2024?

Francis Scotland [00:13:21] Well, it won't be a surprise after listening to all this. I think the biggest surprise is going to be on inflation in terms of how low it may actually get. I'm not sure the U.S. will transit into deflation. I think we'll get some, maybe some zero prints, but I think there's a good chance of undershooting the Fed's inflation target by a not insignificant amount. And we may be talking a lot about deflation this time next year. And if the Fed leans into that inflation story and normalizes the curve, we could have at the end of the year, a year which records or goes out with strong growth and very low inflation.

Katie Klingensmith [00:14:03] Thank you so much, Francis Scotland, for those insights and your outlook for 2024. And thank you, everybody, for listening to this conversation as part of the Around the Curve with Brandywine Global.